United States Department of Agriculture
Farm and Foreign Agricultural Services
Risk Management Agency

TO: Roger C. Viadero
Inspector General
Office of the Inspector General

FROM: Kenneth D. Ackerman
Administrator

SUBJECT: Risk Management Agency Response to Report to the Secretary on Crop Insurance Reform, Published by the Office of the Inspector General

Thank you for providing my office with a copy of your recent *Report to the Secretary on Crop Insurance Reform* 05801-2-At (the Report), published on March 17, 1999.

Over the years, the Office of Inspector General (OIG) and the Risk Management Agency (RMA) have enjoyed a close working relationship that has resulted in significant improvements in the Federal crop insurance program for the benefit of both farmers and taxpayers. Since this Report apparently was not deemed an "audit" under normal OIG procedure, it did not undergo what we consider to be your normal process, such as conducting an exit conference with the subject agency or providing an opportunity for response or correction. While claiming to be based on prior OIG reviews, the Report's conclusions go considerably beyond the facts in the reviews cited. While the Report does raise important policy issues central to today's debate on the future of agricultural risk management, it detracts from a fact-based public dialogue by, among other things, relying on unsupported generalizations and omitting relevant information.

At the same time, the Report does not contain a single recommendation to Congress, even in the instances where Congress has, through legislation, disallowed the specific actions that you recommend the agency take. Often where prior audits are cited, RMA's corrective actions are not reflected.

Before going into a review of the eight issues raised in the Report, the following examples will help illustrate our concerns.

Program Vulnerabilities

At several points in the Report, you state broad conclusions suggesting wide-spread abuse or incompetence based on limited, sporadic findings. Loss adjusters have a "history of errors" and "rubberstamp" improper farmer loss claims; conflicts of interest "persist"; RMA does not "properly research crop insurance policies before implementing them"; and a "systematic flaw" has caused "unreasonably high yield figures" for cotton and corn. Each of these claims stigmatizes an entire group and raises public alarm, yet each is based on anecdotal incidents that do not appear to pass any test of statistical significance.

For instance, while corn and cotton are two of the largest nationwide crop insurance programs being sold in thousands of counties nationwide, the Report cites a problem that existed in a single county for corn and four counties for cotton—all of which have been corrected. With respect to RMA's review of new policies, the examples actually cited in the Report mostly involve highly-complex specialty crops that do not fit the normal mold of heartland commodity policies and comprise a very small portion of the overall book-of-business. Findings regarding loss adjustors are limited to several instances from a program with over a million policies and tens of thousands of professionals. Each reported case of abuse has been addressed through the normal compliance process.

Premium Rates

On the very first page, the Report misstates the basis for crop insurance premium rates, appearing to link company risk-sharing, farmer out-of-pocket cost, and program effectiveness for limited-resource farmers. Premium rates are a central focus of the current reform debate: farmers feel that out-of-pocket costs are too high, particularly in high-risk areas, making buy-up coverage unaffordable. The need for accurate public information on this complex issue is acute.

Crop insurance premiums are based strictly on risk history and judgments of potential loss. Gain-sharing with participating companies is not a factor in this process. Gains and losses for companies are calculated based on net program performance. While the Report suggests a relationship between risk-sharing and program vulnerabilities, it provides no basis or data to support a claim that company and farmer abuses are pervasive enough to systematically impact current premium rates. Without more information on this point, it is inappropriate to include this characterization in the Report.

Budget

The Report is misleading regarding basic public facts. For instance, on page 13, the Report appears to substantially understate the 1998 budget of FSA for salaries and expenses ($721 million vs. an actual $911 million) and overstates the 1998 total government cost (including farmer benefits) of the Federal crop insurance program ($2.1 billion vs. an actual $1.4 billion.) The correct figures are easily accessible in the USDA Budget Summary documents for fiscal year 2000 or the Risk Management Agency, Federal Crop Insurance Corporation's, *Financial Statements for Fiscal Year 1998*, issued by the Office of Inspector General.

Payments to Companies

The central finding of the Report is stated on page 2 of the "Results in Brief" and expanded under Issue I: "As a result of RMA's current risk-sharing policies, more Federal dollars are going to the reinsured companies than are helping producers recover from insurance losses. From 1995 to 1998..., the Government paid the reinsured companies a total of $2.8 billion for delivering the program, $800 million more than it paid in producers' subsidies." As a result, "We suggest that RMA revise its Standard Reinsurance Agreement [SRA] to increase the amount of risk assigned to the reinsured companies...."

During 1997, RMA implemented this recommendation by conducting a major re-negotiation of the SRA. This re-negotiation resulted in a significant increase in the amount of company-borne risk by: (1) increasing overall risk of loss, (2) reducing gain potential on catastrophic policies,

(3) lowering administrative and operating (A&O) payments, and (4) enhancing compliance tools. The new agreement took effect for the 1998 crop year. By basing its findings on the 1995-1998 period, the OIG Report essentially is judging an agreement that no longer exists. Also, Congress acted in 1998 to freeze the financial terms of the SRA. For RMA to pursue the Report's recommendation, a statutory change is necessary.

It is correct that the new SRA does allow companies to gain in a year like 1998, which saw near-record yields for corn and soybean where much of the nationwide commercial business is centered. However, every independent analysis available shows that the new SRA would impose far greater risk of loss on companies over a multi-year period. Further, since 1993, the A&O payments to companies have been reduced from 31 percent of premium down to today's level of 24.5 percent—a step that saves taxpayers over $100 million per year based on current premium values.

While one can always second-guess the outcome of any such complex negotiation, OIG has conducted no review of the 1998 SRA's financial terms, but even if such a review is done, it should be viewed with considerable caution as it would be based on only one year of data. OIG's lack of acknowledgment of the 1998 SRA revisions is puzzling since OIG commented on issues several times during the 1997 negotiations. To my knowledge, not once during or after the negotiations did OIG raise concerns about the 1998 SRA financial gain-sharing and loss-sharing terms.

— A Review of the Issues —

The following is a detailed review of the Report.

General Comments

Page 1, "Results in Brief," first paragraph. The report states "...some RMA policies, particularly those related to risk-sharing with the reinsured companies, have had the effect of increasing premium costs to producers." This statement is incorrect. The distribution of risks between RMA and reinsured companies is not related to premium rates. Premium rates are based on production history and the historical loss experience of each county and State. Rates are established independently of the terms in the SRA.

Page 2, "Results in Brief," first full paragraph. OIG appears to have looked at risk-sharing practices between RMA and reinsured companies between 1995 and 1998. However, current risk-sharing practices are based on the 1998 SRA, where the reinsured companies assume greater risks compared with prior agreements. As such, in the absence of conducting any analysis of the 1998 SRA or any analysis over a more representative period of time, the Report is basing its findings on outdated information.

Page 2, "Results in Brief," last full paragraph. The introduction for the referenced paragraph refers to "Pressure on loss adjustors to rubberstamp policyholders' loss claims." While RMA is constantly reviewing and improving loss adjustment procedures, past OIG audit reports do not identify any specific instance where a loss adjustor was "pressured" to "rubberstamp" loss claims. Use of such terminology, without supporting evidence, is misleading.

Page 3, "Results in Brief," first full paragraph. The Report indicates that by increasing the companies risk of loss, loss adjustors would take greater care in adjusting losses, which "may" result in reinsured companies' revenues becoming more "reasonable" and producers' premiums becoming more affordable. Though premiums are established independently of risk-sharing practices between RMA and reinsured companies, the companies' capital at-risk has in fact risen dramatically—from 33 percent of gross premium written in 1992 to 80 percent in 1998.

Page 3, "Results in Brief," last partial paragraph. The Report states "Some policies actually encourage abuse." This language is inflammatory and appears to overstate the limited findings of OIG's audits.

Page 5, "Results in Brief," last partial paragraph. The report states that RMA needs to take a more proactive role in identifying and reporting weaknesses and ensuring accountability. RMA has demonstrated great effectiveness in preventing and identifying problems, particularly given the large recent growth in the crop insurance program. Although the program is complex compared to commercial insurance markets, crop insurance error rates are well below error rates of commercial insurance markets.

Page 6, "Suggested Corrective Actions," first paragraph. OIG's report suggests that RMA revise the SRA to increase the amount of risk assigned to reinsured companies. Again, lengthy negotiations, in which OIG had an active role, were conducted in 1997 for the 1998 SRA. Among other things, the SRA was revised to reflect a reduction in A&O payments from 29 percent to 27 percent and increased risk assumed by the companies.

Issue 1

Page 9. The Report states that the cost to the government to administer the Federal crop insurance program in 1998 was $2.1 billion. This is incorrect. The actual cost was $1.4 billion, more than $700 million less than OIG's figure.

The Report states that because RMA assigned reinsured companies little risk of exposure on crop losses, the companies' revenue increased over the last 4 years. However, the Report fails to note the increased risk imposed on companies by RMA in the 1998 SRA. For example, the Commercial Fund (where companies assume the greatest potential gains and losses) risk of loss in the working level (loss ratios from 101 percent to 160 percent) increased by two-thirds, from 30 percent in 1993 to 50 percent in 1998.

While companies did receive significant underwriting gains for the 1995-98 period, growing conditions overall were favorable during this time frame. But, according to an independent analysis conducted by USDA's Office of the Chief Economist, should a 1988-type drought occur today under the new SRA, net underwriting losses for participating companies could reach $450 million in a single year.

The Report states, "The companies received these large returns at the same time Congress had to pass supplemental appropriations of $6 billion for reduced farm prices for insured and uninsured crop losses resulting from widespread disaster." This is highly misleading. Last year's Congressional emergency appropriations were designed to address a combination of both low prices and low yields for both insured and uninsured crops. The 1998 crop insurance gains or losses, by contrast, were based on the actuarial performance of the crop insurance book-of-business, which is influenced by the high concentration in commercial business of corn and soybean crops, both of which were produced at near record yield levels in 1998.

Page 10. The Report refers to a 1997 General Accounting Office (GAO) report indicating that the cost to the Government for reinsured delivery of CAT was about $203 per crop policy in 1995 ($76 A&O and $127 in underwriting gains). The Report argues that, since 1995, these CAT costs have more than doubled on a per-policy basis, from $203 in 1995 to about $443 in 1998. While these figures are correct, the Report fails to explain why the cost increased. The average CAT policy has grown sharply in size during this period—from $7,190 of liability per policy in 1995 to $17,900 of liability per policy in 1998. Because the policies are larger, the cost per policy has grown. This fact has driven this cost increase more than any other factor.

It is notable that in its report, GAO specifically recommended that A&O reimbursement to reinsured companies be reduced to 24 percent, based on 1995 commodity price levels. Currently, RMA pays reinsured companies an A&O reimbursement of 24.5 percent, although crop prices have dropped 10 percent to 20 percent, much lower than those referenced by GAO. Thus, it appears that RMA has achieved GAO's target.

Page 11. The Report states in bold typeface that the transition to single delivery for CAT policies in 1998 resulted in significant increases in revenues to the reinsured companies and references Issue 6 for supporting information. The text for Issue 6, however, contains no supporting data for the statement, but rather addresses the servicing of limited-resource farmers. In fact, the text of Issue 6 suggests the opposite conclusion.

Further, an analysis of the SRA encompasses reinsurance years 1995 through 1997; the 1998 reinsurance year is excluded from this analysis altogether. This period is inconsistent even with the 1995-1998 analysis period used elsewhere in the Report.

Page 13. The Report asserts that the estimated FSA budget for 1998 was $721 million. This is incorrect. The actual number was $911 million.

Citing this figure, the Report then suggests that RMA should explore the possibility of a Government-administered delivery system, such as the FSA field structure. While the Report emphasizes that OIG has made no in-depth analysis of the costs of a Government-delivered insurance program, the Department maintained a dual delivery system from 1995 through 1997. Our experience from those years suggests that FSA would require a significant investment in greater staff, training, and infrastructure to deliver crop insurance. Curiously, the Report suggests RMA consider having FSA administer only the CAT program while reinsured companies continue to deliver buy-up policies—essentially creating redundant delivery systems for the same program.

Issue 2

Pages 14-15. The Report states that reinsured companies do not have sufficient controls to prevent or detect conflict of interest situations. OIG's report does not cite any pervasive pattern of conflict of interest situations. Out of approximately 1.2 million policies, OIG found only isolated instances of possible conflicts of interest. In the example cited on page 15, the Report states that a particular sales agent with a customer base of about 350 policies only had four policyholders not receiving an indemnity in 1997. Without further analysis and explanation, evidence of conflict of interest is not supportable because the sales agent's policies may have been largely comprised of policies in an area that was impacted by severe drought or other prevailing circumstances.

Issue 3

Pages 17-19. The Report states that loss adjustors made errors when (1) calculating crop income and production to count, (2) determining insured acreage, (3) verifying unit structure, and (4) determining producer compliance with policy requirements. The Report also suggests that RMA take a more proactive role in monitoring reinsured company oversight and quality control reviews of loss claims. RMA is currently implementing these actions and, based on periodic updates, OIG was well aware of RMA's actions prior to issuance of the Report.

RMA currently requires reinsured companies to conduct quality control reviews on a selected sample of indemnified policies, which entails an analysis and conclusions regarding loss adjustment practice. RMA conducts follow-up spot checks on company quality control reviews to ensure accuracy and completeness in the methodology utilized and also conducts its own review of large claims. RMA has repeatedly been successful in recovering monies from reinsured companies for errors committed by company employees or representatives, such as a claim against raisin growers in California. The Report fails to recognize any of these remedial actions by RMA, giving a distorted picture of the ongoing effectiveness of RMA's compliance oversight program.

Issue 4

Page 20. The Report states, "This systemic flaw has resulted in unreasonably high yield figures in such program crops as cotton and corn ...." The high yield figures for cotton were limited to four counties in Texas and the high yield figures for corn (other than dryland popcorn, a separate crop) were limited to a single county in Texas. To RMA's knowledge, OIG has not uncovered widespread yield problems on corn or cotton other than these five, while the programs themselves are available in thousands of counties nationwide.

Page 21, Crop Insurance on Fresh Market Tomatoes. The Report states, in the case of fresh market tomatoes, that indemnities were paid when market prices were low and there was no loss in quantity or quality of the production. RMA is not aware of any specific case where this finding was supported. With respect to the referenced $41,430 indemnity, this did not appear to be a case where an indemnity was paid because of a decrease in market prices. The documents clearly showed that a hurricane and frost, both insurable causes of loss, caused the tomatoes to be unmarketable because of poor quality, odd shapes and sizes, or scarred split and on the ground. As such, OIG's quote concerning a memo in the producer's records, "we elected not to pick this field ... ," was taken out of its proper context.

The second paragraph regarding Fresh Market Tomatoes also takes information out of context. The OGC legal opinion did not involve factual issues, but rather posed questions to OGC regarding the legality of incorporating certain language in the Special Provisions or quantifying damage thresholds for this particular policy.

Page 22, Crop Insurance Coverage for Pima Cotton, Popcorn, and Corn in Texas. The Report states that farmers were offered dryland crop insurance coverage for popcorn in an area where the normal rainfall was not sufficient to produce a crop. As RMA has indicated in responses to a previous audit report, coverage for non-irrigated popcorn was not a suitable farming practice for that area and RMA revised the actuarial documents for the 1999 crop year to ensure popcorn coverage is only provided for irrigated acreage. However, RMA's corrective actions are not reflected in the Report.

Note: In 1998, the Rio Grande Valley received an abundant amount of rainfall and all of the popcorn acreage produced average or above-average yields. The indemnities paid were due to poor quality of some of the production (pop-ability and aflatoxin) and not inadequate rainfall.

Page 23, 1994 Reinsured Raisin Losses in California. The Report discusses improper loss payments and states that these payments could have been avoided if the policy flaws had not existed. This is not accurate. The losses actually resulted from fraudulent statements made by some producers, agents, loss adjusters, and third-party processors. Criminal indictments have been obtained and other civil cases are pending. OIG, with RMA's assistance, identified and investigated the improper 1994 losses while RMA was in the process of revising the policy and loss adjustment procedures. The revisions are now complete but are not recognized in OIG's report.

Page 23, Guaranteed Prices for 1999 Durum Wheat Under Crop Revenue Coverage. The Report states, "Critics have noted that RMA's guaranteed price for durum is excessive in comparison with the market price, and they have alleged that producers will plant excessive acreage of durum because of the potential for large insurance indemnities." Because of unforseen market movements, the Crop Revenue Coverage (CRC) Durum Wheat Base Price methodology generated prices higher than the actual market price for durum wheat. RMA acted promptly to correct the situation. Specifically, upon awareness of this problem, RMA announced that the creator of the policy had amended the CRC Commodity Exchange Endorsement for 1999 durum wheat, which reduced the base price from $1.92 a bushel to $1.15 per bushel. This matter is in litigation.

Page 24, Initiatives by Reinsured Companies Also Need Oversight. The Report discusses the controversies surrounding the CRC-Plus policy. CRC-Plus is not a federally-regulated product. RMA requested OIG assistance in reviewing the situation that arose with respect to this product in March 1999, prior to issuance of the Report. However, OIG has chosen not to investigate this matter further. RMA has worked effectively with the National Association of Insurance Commissioners to assist the States responsible for regulating this product, and has continued to explore its own compliance options with respect to the company associated with the policy. None of these actions is reflected in the Report.

Page 25, Suggested Corrective Action. The Report proposes that "RMA needs to perform more extensive analyses of crop insurance policies before implementation, particularly as to the effect on RMA's liability." As a matter of course, RMA conducts extensive analysis on all crop insurance policies prior to implementation, including both those developed by the agency and those developed by private parties. With respect to so-called "wrap-around" or "add-on" policies like CRC-Plus, RMA reviews all submitted policies to determine if there is a potential to shift risk to the underlying federally reinsured policy. During these reviews, RMA staff often consult with the developer of the product to analyze how the product will operate under different scenarios. RMA has raised concerns on several private products with the developing company, which resulted in changes to the private product.

The Report suggests, as its principal solution, that RMA work with reinsured companies to develop a computer model to test policies before implementation. Such a model may be useful in some cases, but this approach has serious limitations. Computer models can help to indicate whether or not the rating is adequate where policies are properly underwritten (designed). But it is impossible to develop a model that will predict every scenario that may occur, be it accounting for long-term climatological characteristics, plant growth patterns, weather conditions, or producer decisions. As the Report itself shows, the policies that have been problematic are the specialty crops where unanticipated conditions arise, exactly the type that would not be prevented by OIG's proposal.

Issue 5

Page 27. The Report recommends that RMA consider rescinding its optional unit policy or take other remedial action. As a matter of public policy, we disagree with eliminating optional units. Such a step would gravely disadvantage hundreds of thousands of farmers who rely on this feature as a vital risk management tool, the vast majority of whom act with integrity and honesty.

Issue 6

Page 27. The Report states, "We feel that reinsured companies are not utilizing the substantial underwriting gains received under the FCIC crop insurance programs to encourage and expand crop insurance coverage to as many producers as possible, regardless of size." The reduction in CAT policies sold to limited-resource producers are not related to the failure of reinsured companies to redistribute underwriting gains or to the transfer of this program from dual delivery (by reinsured companies and FSA) to single delivery by reinsured companies. Instead, the problem is with the statutory terms of this program, and RMA has proposed statutory revisions in this area. The CAT policy is designed to provide coverage for very infrequent events and, as such, producers do not receive indemnities often and, when they do, these indemnities tend to be small relative to crop value. On average, limited-resource producers farm 16 acres and usually do not collect large indemnities because the insured value of their crops is small. Farmers want higher levels of coverage, which CAT does not deliver.

Page 28. The Report states that the current $50 administrative fee for CAT policies is a source of revenue for the reinsured companies. This is wrong. Congress, through the 1998 Research Act, changed the program to provide that the administrative fee, which is currently $60, goes to the Federal Government.

Page 29. The Report suggests that RMA should consider assigning an increased value to CAT imputed premiums for small producers. This proposal is not allowed under current law because the A&O operating expense is set by statute and premiums are calculated based on anticipated losses. If RMA adjusted premiums to include greater incentives to companies, it would fundamentally violate the notion of "actuarial soundness" and lead to inflated underwriting gains.

Issue 7

Pages 3-4, 20, 30–Nursery Insurance. RMA participated heavily in OIG's 1998 audit of nursery. In response to that audit, RMA implemented major revisions to the nursery program, effective for the 1999 crop year. For instance, prices were issued to more accurately value the nursery crops and reduce the possibility for moral hazard. Development of the new nursery program, as well as RMA's role in developing and addressing the issues, are absent from the Report—again creating a misimpression regarding the agency's role.

Page 32. The Report states that Regional Service Offices (RSO's) were not required to provide input or participate in new product development. OIG cites development of coverage for melons as an example. In fact, for melons, leadership for the development team was provided by the

RSO's and several RSO representatives served as team participants. RSO's are highly engaged in the development process and any suggestion to the contrary is simply false.

Issue 8

Page 34. The Report repeats concerns previously identified by OIG in an audit report on RMA's compliance function, for which a management decision was reached on all the findings and recommendations. However, the Report does not mention RMA's actions to implement these improvements within the scope of available budget and staffing.

— Conclusions —

Since 1994, RMA has rectified many of the critical issues that plagued the earlier program. We have consistently met our underwriting targets, substantially increased participation, and greatly multiplied the number of tools farmers have available to manage their risks through our vigorous public-private sector partnerships. Undoubtedly we have made mistakes during this period of rapid growth and expansion. However, once errors were identified they were remedied.

RMA's strategic plan states that ensuring the integrity of the program is one of the three principal objectives of the Agency. Because insurance protection costs farmers cold, hard cash, maintaining their confidence in the program is critical to the entire agricultural economy. Over the next several months, USDA and the Congress will conduct an important debate over the future shape of these programs, particularly Federal crop insurance, based largely on a review of how these programs performed during recent years of significant price decline. Feelings on these issues are strong. RMA is fully prepared to accept its share of legitimate criticism, account fully for its actions, and make adjustments where necessary. In this debate, it is vital for all participants in this process to provide the public with accurate, measured, and documented information.

In this regard, OIG carries a particularly heavy burden. The public accords OIG reports a high degree of credibility, both because of OIG's independence and because the public assumes OIG to have based its finding on rigorous audit standards, careful quality-control procedures, and measured analysis. Your staff has chosen neither to seek input from RMA in preparing this report nor to brief us either prior to or after its release; therefore, we are compelled to respond through this letter to the report.

cc: Secretary Dan Glickman
Members of Congress